

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Bates Analyst: John J. Pavalasky Bill Number: AB 2358
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 21, 2002
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Exclusion/Gain From Stock Option In High Technology Business

SUMMARY

This bill would not tax any gain from the acquisition, sale, or exchange of a stock option in a California high technology business by an investor in the business or by an employee, officer, or director of that business.

PURPOSE OF THE BILL

According to the author's staff this bill's purpose is to encourage investment in the high tech sector.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately and apply to taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

According to the author's staff, a definition of the term "qualified high technology business" will be amended into the bill. Department staff is available to assist with amendments to resolve the implementation and technical concerns discussed in this analysis.

ANALYSIS

FEDERAL/STATE LAW

Stock options are contracts that allow the owner of the option to purchase stock at a specified price and are usually valid for a specified period of time. In general, under both federal and state law, stock options between the company and its employees, officers, and directors (called "compensatory options") are treated differently than stock options obtained in an established market for stock options (called "noncompensatory options").

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for GHG

5/15/02

Compensatory Options

1. The first step in compensatory options is to determine the amount of the "bargain element" of the option since that constitutes the amount of compensation required to be included in the employee's, officer's, or director's income. The "bargain element" is the difference between the fair market value (FMV) of the underlying stock and the amount the employee, officer, or director must pay to acquire the stock.

2. The second step is to determine the taxable year in which the "bargain element" is included in income. It is possible that some portion of the "bargain element" is taxed when the option is granted and an additional portion may be taxed on the exercise of the option. In addition, under the alternative minimum tax (AMT) the "bargain element" of a stock option granted to an employee, officer, or director is a tax preference item and included in the employee's, officer's, or director's AMT computation in the year the option is granted, even if the FMV of the stock goes down later.

Noncompensatory Options

1. First, the taxpayer must determine whether the gain or loss is capital or ordinary. Gain or loss from the sale or exchange of a noncompensatory option to buy or sell stock is treated as a capital gain or loss if the underlying stock is (or would be if acquired) a capital asset in the hands of the taxpayer. A dealer in options is considered a dealer in the underlying stock, and any gain or loss recognized is ordinary income or loss.

2. Second, there are no tax consequences to the buyer or writer of an option until the option is exercised or otherwise closed out, or lapses. The holder treats any premium paid as a nondeductible capital expenditure at the time of payment and the writer treats any premium received as part of the sales price. If the option is not exercised (lapses), so that the writer simply keeps the money, the income is included in the taxable year in which the option lapsed. Certain anti-abuse rules have been created to restrict a taxpayer's ability to defer recognition of gain on appreciated property he owns even though he locks in his gain and limits risk of loss through sophisticated option transactions. Essentially the taxpayer is treated as constructively selling property he owns if he borrows and sells the same or substantially identical property.

THIS BILL

This bill would exclude from gross income any gain from the acquisition, sale, or exchange of a stock option in a "qualified high technology business" located in California. The definition of a "qualified high technology business" is undefined.

IMPLEMENTATION CONSIDERATIONS

Without a definition of the term "qualified high technology business," the department would not be able to implement this bill.

The bill requires that a "qualified high technology business" be located in California. The term "located" needs to be defined. Does this mean that all of the company's operations must be conducted wholly within California to qualify or only a small part of the overall operations? For example, the California small business stock provision uses the criteria that at least 80 percent of the corporation's payroll, as measured by total dollar value, is attributable to employment located within California in order for the company's stock to qualify under the California provision.

In addition, the terms “acquisition” and “exchange” need to be specifically defined in order to determine which stock transactions are covered by the exclusion provided by this bill. Without clear definitions of these terms, substantial controversy regarding the stock transactions that are excluded from income would occur.

TECHNICAL CONSIDERATIONS

According to the author’s staff the bill was not intended to change the AMT treatment of the acquisition of a stock option as a preference item.

LEGISLATIVE HISTORY

This is the first bill that proposes a 100% exclusion from tax for any gain from stock options.

OTHER STATES’ INFORMATION

Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide an exclusion from income comparable to the exclusion allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California’s income tax laws.

FISCAL IMPACT

If the bill is amended to resolve the implementation and technical considerations addressed in this analysis, the department’s costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be a revenue loss in excess of \$3 billion per year beginning with the fiscal year of 2002/03. Stock options treated as wages account for most of the revenue impact.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this exclusion from income would depend on the amount of stock options acquired, sold, or exchanged in any given year. Four potential impact areas apply: (1) the wage component of options, (2) capital gains from options, (3) ordinary income of option dealers, and (4) alternative minimum tax (AMT).

The Department of Finance estimated that option-related wages would account for about \$50 billion in 2003. Since high-tech corporations often offer stock options, and the term high-tech is not defined, it is assumed that 95% of this amount would qualify for exclusion under this bill. It is further assumed that the average California income tax rate for the option-related wages is 7%. The revenue loss is estimated at \$3,325 million as follows:

$$\$50,000 \text{ million wage} \times 95\% \text{ qualified} \times 7\% \text{ tax rate} = \$3,325 \text{ million}$$

Revenue losses due to capital gains from options, qualified ordinary income of option dealers, and AMT are estimated to be much less, on the order of \$100 million annually.

Significant behavioral responses to this bill will most likely occur (i.e. more wage options granted than otherwise) but are not included in the above estimate.

ARGUMENTS/POLICY CONCERNS

The exclusion provided by this bill is limited to gain from transactions relating to the stock option itself and not gain resulting from the acquisition, sale, or exchange of the stock of the qualified high technology business. This bill, thus, does not exclude from gross income the gain from the exercise of a stock option in a qualified high technology business unless the term “exchange” used in the bill is intended to include that transaction. The author may want to clarify whether the gain from the exercise of a stock option in a qualified high technology business is excluded by this bill.

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